

## MEMORANDUM SUMMARIZING THE EFFECTS OF A SCANA BANKRUPTCY ON THE RATE PAYERS

This memorandum provides a summary of possible effects of a bankruptcy filing by SCANA and/or South Carolina Electric & Gas Company ("SCE&G") on the SCE&G rate payers. The summary provided herein does not attempt to address all potential impacts, or to discuss in full detail the possible effects of a bankruptcy on the rate payers. A fuller discussion can be provided after receipt of this summary, if desired.

### The Possible Effects of a SCANA or SCE&G Bankruptcy

The primary effects of a bankruptcy filing by SCANA and SCE&G on the rate payers would be (1) to potentially limit recovery of the special rate charges previously paid by rate payers for the failed V.C. Summer Nuclear Plant reactors 2 and 3 (the "Project"), (2) to initially stay actions by rate payers against SCANA and SCE&G, (3) to change the forum in which rate payer claims against SCE&G are litigated, and (4) the possible change in the provider of the utility services to the rate payers, such as if SCE&G or its assets were sold. Each of these effects is discussed below.

1. The Potential Limitation on Recovery by Rate Payers of the Special Rate Charges Already Paid to SCE&G for the Project. This potential limitation arises by possible application of the automatic stay which becomes effective upon the filing of a bankruptcy case, pursuant to 11 U.S.C. § 362(a), and the possible treatment of the rate payer claims as general unsecured claims against the SCE&G bankruptcy estate. If the automatic stay is applicable to the recovery of payment, the rate payers may not receive any payments on these claims until a Chapter 11 plan is confirmed or the assets of SCE&G are liquidated (if such liquidation were to produce enough value to enable payment to unsecured creditors). In addition, in most Chapter 11 cases, unsecured creditors receive only a partial payment of their claims. However, as discussed below in this memorandum, the doctrine of recoupment may apply to the claims. If so, the automatic stay may not preclude the rate payers from recovery by means of withholding payment (or a portion of payments) to SCE&G for current and future service charges. In this regard it must be noted that the withholding of payments to SCE&G may not be factually viable, or desirable, based on the economic reality that cutting off or substantially reducing SCE&G's revenues could seriously impact its ability to provide service to its customers. As such, even if recoupment is proper, it appears more likely that a plan of partial credits to the rate payer accounts, in increments which would not jeopardize the continued provision of service to rate payers, would be developed.

2. Stay of Rate Payer Actions Against SCE&G. A bankruptcy filing by SCE&G would stay rate payer actions against SCE&G pursuant to 11 U.S.C. § 362(a). The allowance of claims and the determination of claim amounts are deemed to be an essential part of the bankruptcy process. For most claims, the terms of payment will be determined as part of the bankruptcy case. However, if the rate payers are entitled to recoupment as a means of payment of their claims, it is possible that the payment determination may be made on a different track than for other claims. It is likely that the Bankruptcy Court would still be involved in the determination—due to the critical nature of the revenue SCE&G receives and relies upon from its rate payers—in some capacity, which

could be to simply approve a recoupment arrangement, or to enjoin recoupment pending development of a payment arrangement which would not jeopardize the reorganization.

3. Change in Forum for Litigation of Rate Payer Claims. Actions filed by rate payers against SCE&G will be stayed. The rate payers will need to file claims in the bankruptcy case, and, generally, the claims will be determined in the bankruptcy case.<sup>1</sup> The Bankruptcy Court determines the overwhelming majority of claims in bankruptcy cases, but some exceptions exist in which a claim(s) may be determined in another court or forum. If rate payer claims arise by changes to the provisions or effect of the Base Load Review Act, or by a determination that the legislation allowing SCE&G to recover its costs for the Project is unconstitutional, or by a determination made under the police and regulatory powers of the State of South Carolina, the rate payer claims may be determined by another court, agency or governmental body. This question would likely be a contentious matter.

4. Possible Change in Provider of Utility Services. If it were to file a Chapter 11 bankruptcy case, it appears that SCE&G would seek to reorganize. However, a common outcome of Chapter 11 cases is a change in ownership (the cancellation of existing shares of stock is discussed later in this memorandum), or a sale of assets. In some cases, the reorganization includes a sale of some but not all assets, as a means of reducing debt and streamlining operations. In many cases, all or substantially all assets are sold, often constituting a *de facto* sale of the business. Many potential purchasers prefer a bankruptcy sale to a sale outside of bankruptcy, because the Bankruptcy Court may order the sale of assets free and clear of liens, claims, encumbrances and other interests.<sup>2</sup> Although a sale may not be initially proposed, the possibility exists in a bankruptcy that a sale could result, thus changing the provider of the utility services now provided by SCE&G.

### **Reasons Why SCANA and SCE&G Might File a Chapter 11 Bankruptcy Case.**

SCANA and SCE&G are subject to numerous claims by contractors, vendors, rate payers, regulators, consumer advocates, and shareholders, all arising in connection with the failed construction project for new reactors 2 and 3 at the V.C. Summer Nuclear Plant. The South Carolina Legislature is considering new legislation and/or rescission of previous laws which would significantly affect SCE&G's rates charged to its customers, and, hence, its income. Although SCANA and SCE&G have been profitable companies for decades, the many claims and threatened actions against them, and the concomitant substantial costs to respond, address and defend them, imperil the viability of the two companies prospectively. A Chapter 11 bankruptcy may become necessary or desirable as a means to address these matters.

Chapter 11 is a set of provisions under the United States Bankruptcy Code, 11 U.S.C. § 101, *et seq.* (the "Bankruptcy Code"), which may enable the companies to reorganize their business and financial affairs in order to survive as ongoing businesses, or to arrange an orderly sale of assets

<sup>1</sup> It is possible that someone, possibly ORS or another agency, may be authorized to file claims for the rate payers, given the nature of the rate payer constituencies, the volume of claimants, the need for allocation of aggregate claim amounts among rate payers, and other similar considerations.

<sup>2</sup> There are some encumbrances and interests as to which the Bankruptcy Court cannot order the sale to be free and clear, *e.g.*, certain restrictive covenants of record relating to real property, zoning ordinances, etc.

that will maximize value under the circumstances. Under a Chapter 11 plan, the company may recast the terms of repayment of debt and claims against it. Depending on the facts of the case, the Chapter 11 plan may not require full payment of all creditors. The company may be able to extricate itself from unfavorable contracts and leases. Subject to certain limitations, the assets of the company may be sold free and clear of liens, claims, encumbrances and other interests.

Chapter 11 offers many possible benefits, but, as one might expect, there are many possible detriments to a filing under Chapter 11. The company must weigh the benefits and detriments carefully before filing a Chapter 11 case.

For SCANA and SCE&G, a Chapter 11 filing would stay creditor and shareholder actions against them seeking payment of debt or damages claims, and generally place all such claims in one court, the United States Bankruptcy Court. The benefit of having all creditor claims in one forum, under one reorganization proceeding, with all creditor constituencies at least figuratively present in one court, is very substantial. Often it is the only means by which a reorganization can occur. For SCANA and SCE&G, this benefit could become compelling grounds for filing a Chapter 11 case.

#### **The Bankruptcy Filing Would Not Stay Government Actions Relating to Enforcement of Police and Regulatory Powers**

Notably, the automatic stay arising upon the bankruptcy filing will not stay actions and proceedings of a governmental agency or unit to enforce police or regulatory powers of that agency or unit. 11 U.S.C. § 362(b)(4). A Chapter 11 filing by SCANA and/or SCE&G would not stay the South Carolina Public Service Commission (the "Public Service Commission") from performing its role in the approval or disapproval of requested rate increases, or the South Carolina Office of Regulatory Staff ("ORS") from performing its role in protecting the public interest, including the interests of rate payers with regard to ongoing operations. The bankruptcy automatic stay does not apply to criminal investigations, as are now in process both by South Carolina authorities and Federal authorities. The Chapter 11 filing would not allow SCE&G to set its rates or make assessments upon rate payers without the involvement of ORS and the approval of the Public Service Commission (or approval by a South Carolina court ruling upon an appeal of a Public Service Commission decision).

However, the police and regulatory powers exception to the automatic stay generally does not apply to a governmental action to collect a debt.<sup>3</sup> In this regard, actions by agencies of the State of South Carolina or of the Federal government which are debt collection, *e.g.*, collection of a loan indebtedness or prepetition taxes (taxes owed for periods prior to the bankruptcy filing), are stayed by the bankruptcy filing. Where the government action involves a payment by the company, the applicability of the automatic stay to such action is normally determined by (a) whether the action is one for enforcement of police or regulatory powers, usually affecting the public health or safety or other important public interests, and (b) is the amount sought attributable to prepetition (pre-bankruptcy) conduct. The first consideration concerns whether the action is really a debt collection action, which would be stayed, while the second consideration concerns

<sup>3</sup> Depending on the nature of the matter, the governmental agency may be able obtain stay relief to collect certain debt obligations which are related to police or regulatory powers.

whether the amount sought, even if a debt collection, is a post-petition obligation which would not be stayed.<sup>4</sup>

If SCE&G were to file a Chapter 11 case, the nature and character of any repayment obligation it may have to the rate payers for amounts it collected from them for the Project would almost certainly be in issue. Also, it is likely that prospective charges to rate payers by SCE&G to recover its investment in the Project, which recovery it maintains is already authorized under the Base Load Review Act, would be in issue.

In addition to arguments SCANA and SCE&G would make regarding the binding effect of the Base Load Review Act on amounts previously collected, and on amounts SCE&G maintains that it is entitled to charge for recovery of its investment in the Project, SCE&G would likely argue that bankruptcy law precludes the Public Service Commission (and any appellate court) from requiring repayment and/or denying recovery of additional amounts. SCE&G would argue that any decision or change in legislation requiring that it repay the amounts it previously charged rate payers would be in the nature of debt collection. It would argue that the "debt" must be addressed in the same context as other debts and obligations it owes to creditors, *i.e.*, as part of its bankruptcy case. With regard to the asserted right to recover its investment in the Project by future charges to rate payers, SCE&G would likely argue that this right of recovery is an asset it owns, not unlike an account receivable or other contract right of recovery. SCE&G would thus argue that the automatic stay applies to preclude both any requirement by the Public Service Commission that SCE&G repay amounts it previously collected, and any attempt to deny it the right to collect future amounts for recovery under the Base Load Review Act.

Even where the automatic stay is applicable to an action, the government agency or unit may be able to obtain relief from the automatic stay to allow it to proceed with its action. For example, if ORS were to seek relief from the automatic stay so that it might present a matter to the Public Service Commission involving SCE&G payment obligations, the Bankruptcy Court might grant ORS relief to proceed if the Bankruptcy Court found that the matter was one involving the exercise of police or regulatory powers or functions.

#### **Possible Determination of Recoupment by Rate Payers**

Recoupment may be available as a means for rate payers to collect amounts owed to them by SCE&G. If the Public Service Commission or an appellate court determines that SCE&G must repay the amounts it collected from rate payers for the Project, the issue likely will arise as to whether the repayment may be made by set-off or recoupment. If done voluntarily, it is likely that SCE&G would credit the rate payer's account rather than send payments to each rate payer, and that SCE&G would provide the credits in incremental amounts over time, essentially as a payment plan. If SCE&G did not voluntarily adopt this kind of payment plan, the same outcome might be accomplished by set-off or recoupment. Recoupment would be preferable to set-off for rate payers.

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<sup>4</sup> Even though the enforcement of a post-petition obligation may not be stayed under 11 U.S.C. § 362(a), collecting payment of the obligation from the company or its assets may not be possible except through bankruptcy process, depending on the stage of the case. The post-petition obligations generally would be entitled to administrative priority status in the bankruptcy.

Set-off is possible when there are mutual obligations between the same parties. Recoupment, similarly, is between the same parties regarding mutual obligations, but the obligations are part of a contract or relationship course of dealing that is still in process. Outside of bankruptcy, the distinction between set-off and recoupment is generally not material to the parties. However, in bankruptcy, the distinction has a very significant effect.

When a bankruptcy is filed, the right of set-off is treated as a secured claim. It is limited, however, to set-off of prepetition obligations between the parties. In other words, a rate payer could not set-off an amount owed to the rate payer for a repayment obligation which arose prior to the bankruptcy filing (e.g., such as if SCE&G were required to repay the charges it collected from rate payers for the failed Project) against charges for service to the rate payer after the bankruptcy filing. Provisions in the Bankruptcy Code preclude the use of new charges incurred by the rate payer for recovery (by attempted set-off) of prepetition debt to the rate payer.

In contrast, recoupment is not subject to the automatic stay. The application of credits against obligations is deemed to be in the nature of an ongoing reconciliation of amounts due to each party in the course of the transaction or ongoing relationship, essentially a continuous (or continuing) transaction in which the parties will net out obligations between them and determine a final amount due (if any) at the end. An example of this type of exchange is the handling of Medicare and Medicaid cost reimbursements to hospitals by the Centers for Medicare and Medicaid Services (“CMS”) of the U.S. Department of Health and Human Services, which obtains an audit of the hospital’s reimbursed costs in prior years. When CMS determines that a hospital has been overpaid (based on the audit), CMS is entitled to withhold payments for current and future costs reimbursements; courts have held that the withholdings are recoupment, and not subject to the automatic stay in a bankruptcy, because the withholdings are part of the ongoing relationship. If a hospital or other healthcare provider wants to avail itself to the benefits of the Medicare and Medicaid reimbursement programs, the “cost” of participation is that overpayment obligations may be withheld by CMS from future payments. There is no annual contract, but, instead, an ongoing program participation.

Similarly, the utility service provided by SCE&G to rate payers is not an annual contract that is renewed or terminated based on a defined calendar period, but an ongoing relationship between SCE&G and the rate payer. As part of the ongoing service provider-customer relationship, adjustments may be made as necessary or appropriate to bring the account into compliance with each party’s obligations to the other party. This adjustment and reconciliation of the account is consistent with SCE&G’s asserted right to charge rate payers for the amount(s) SCE&G seeks to recover its investment in the Project. The rate payer’s obligation to pay additional amounts for SCE&G’s recovery of investment is not based on the service provided to or used by the rate payer; it is based completely on the parties’ ongoing relationship.<sup>5</sup> In the same vein, if it is determined that SCE&G owes money back to the rate payer, it should also be treated as part of the ongoing relationship between SCE&G and the customer.

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<sup>5</sup> The rate payers charged for the recovery of SCE&G’s investment would be current and future rate payers. It does not appear that any demand will be made to former rate payers who have moved and/or no longer have an account with SCE&G.

The bottom line for rate payers regarding recoupment, as opposed to set-off, is that a bankruptcy filing should not stay the rate payers from withholding payment from SCE&G until they (the rate payers) have fully recovered the amount(s) SCE&G owes to them. It should be expected, of course, that SCE&G would vigorously oppose this characterization of the repayment rights of the rate payers as recoupment for this reason. Most likely, the right of recoupment would serve as a basis for agreement of a repayment plan, probably involving a credit to the rate payer's monthly bill for current and future SCE&G service.

### **Bankruptcy Implications for SCANA and SCE&G Shareholders**

A bankruptcy filing by SCANA and/or SCE&G could have dire consequences for their shareholders. The rights and interests of shareholders, as "equity interest holders," are subordinate to the right of payment of creditors. Pursuant to Bankruptcy Code provisions regarding the order of distribution of funds by a bankruptcy trustee or Chapter 11 debtor-in-possession, funds are available for equity interest holders (*e.g.*, the shareholders) only after all allowed creditor claims are fully paid. Similarly, with regard to a Chapter 11 plan, pursuant to the Absolute Priority Rule (codified in 11 U.S.C. § 1129(b)(2)(B)(ii)), the equity interest holders (shareholders) cannot receive or retain any value – not even continued ownership of the company – unless either (a) the allowed claims of all unsecured creditors are paid in full, or (b) the unsecured creditors accept the plan allowing the shareholders to receive or retain value. These provisions could result in the extinguishment of the shareholders' interests.

Most Chapter 11 cases do not result in full payment of creditors. Most Chapter 11 cases result in either cancellation/extinguishment of existing equity interests (*e.g.*, shares of stock), or modification of their rights. Accordingly, this possible extinguishment of shareholder interests is a factor which would reinforce the resolve of SCANA and SCE&G to avoid filing a bankruptcy case, if possible.

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